



Billing Code 4810-25-P

DEPARTMENT OF THE TREASURY

31 CFR Part 148

Qualified Financial Contracts Recordkeeping Related to Orderly Liquidation Authority

AGENCY: Department of the Treasury.

ACTION: Notification of exemption.

SUMMARY: The Secretary of the Treasury (the “Secretary”), as Chairperson of the Financial Stability Oversight Council, after consultation with the Federal Deposit Insurance Corporation (the “FDIC”), is issuing a determination regarding a request for an exemption from certain requirements of the rule implementing the qualified financial contracts (“QFC”) recordkeeping requirements of Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act” or the “Act”).

DATES: The exemption granted is effective [INSERT DATE OF PUBLICATION IN FEDERAL REGISTER].

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SUPPLEMENTARY INFORMATION:

Background

On October 31, 2016, the Secretary published a final rule pursuant to section 210(c)(8)(H) of the Dodd-Frank Act requiring certain financial companies to maintain records with respect to their QFC positions, counterparties, legal documentation, and collateral that would assist the FDIC as receiver in exercising its rights and fulfilling its obligations under Title II of the Act (the “rule”).¹

¹ 31 CFR part 148; 81 FR 75624 (Oct. 31, 2016).

Section 148.3(c)(3) of the rule provides that one or more records entities may request an exemption from one or more of the requirements of the rule by writing to the Department of the Treasury (“Treasury”), the FDIC, and the applicable primary financial regulatory agency or agencies, if any.² The written request for an exemption must: (i) identify the records entity or records entities or the types of records entities to which the exemption would apply; (ii) specify the requirements from which the records entities would be exempt; (iii) provide details as to the size, risk, complexity, leverage, frequency and dollar amount of QFCs, and interconnectedness to the financial system of each records entity, to the extent appropriate, and any other relevant factors; and (iv) specify the reasons why granting the exemption will not impair or impede the FDIC’s ability to exercise its rights or fulfill its statutory obligations under sections 210(c)(8), (9), and (10) of the Act.³

The rule provides that, upon receipt of a written recommendation from the FDIC, prepared in consultation with the primary financial regulatory agency or agencies for the applicable records entity or entities, that takes into consideration each of the factors referenced in section 210(c)(8)(H)(iv) of the Act⁴ and any other factors the FDIC considers appropriate, the Secretary may grant, in whole or in part, a conditional or unconditional exemption from compliance with one or more of the requirements of the rule to one or more records entities.⁵ The rule further provides that, in determining whether to grant an exemption, the Secretary will consider any factors deemed appropriate by the Secretary, including whether application of one or more requirements of the rule is not necessary to achieve the purpose of the rule.

Request for Exemption

On April 19, 2017, Morgan Stanley submitted, on behalf of Morgan Stanley Smith Barney LLC (“MSSB”), a request for an exemption from the rule to Treasury, the FDIC, and, as the primary financial

² 31 CFR 148.3(c)(3).

³ 12 U.S.C. 5390(c)(8), (9), and (10).

⁴ 12 U.S.C. 5390(c)(8)(H)(iv).

⁵ 31 CFR 148.3(c)(4)(i).

regulatory agencies for MSSB, the Securities and Exchange Commission (“SEC”) and the Commodity Futures Trading Commission (“CFTC”), which Morgan Stanley supplemented with information provided on March 26, 2018.⁶ Morgan Stanley requested an exemption for MSSB from compliance with sections 148.3 and 148.4 of the rule for MSSB’s current and future QFC portfolio consisting of QFCs entered into by MSSB on behalf of customers and booked and carried in accounts for the benefit of customers, referred to in the request as “client activity QFCs,” and QFCs with central counterparties under which client transactions executed by MSSB are cleared and settled. Morgan Stanley also requested that the exemption apply to inter-affiliate QFCs entered into for the purpose of fulfilling client activity QFCs, funding its client activity QFCs, or hedging risks arising from such QFCs or for similar purposes in support of its business relating to such QFCs. As an alternative, Morgan Stanley requested that the Secretary allow MSSB to comply with the recordkeeping requirements of the rule by maintaining the records that MSSB already maintains on its QFCs for business reasons and pursuant to other regulatory requirements.

In support of its request, Morgan Stanley submitted information detailing the types and large volume of client activity and related QFCs, measured by both number of QFCs and market value, to which MSSB is a party. Morgan Stanley represented that the client activity QFCs are generally cash transactions entered into by retail customers, including individuals and small and medium sized businesses, that are executed on standardized terms, and loans to retail customers such as margin loans and demand lines of credit that are subject to standardized terms and documentation. Morgan Stanley represented that MSSB’s client activity QFCs are typically not leveraged and that with respect to client activity QFCs that are margin loans or foreign exchange (“FX”) products whereby MSSB extends credit, such QFCs are typically over-collateralized in compliance with applicable law. Morgan Stanley also stated that MSSB’s interconnectedness to the rest of the financial system is limited, given that it serves

⁶ MSSB is registered with the SEC as a broker-dealer under the Securities Exchange Act of 1934 and as an investment adviser under the Investment Advisers Act of 1940 and is registered with the CFTC as an introducing broker under the Commodity Exchange Act.

retail customers and given the limited complexity of the products it offers. Morgan Stanley has a separate U.S. broker-dealer subsidiary, Morgan Stanley & Co. LLC, that serves institutional clients. Morgan Stanley noted that only a very small percentage of MSSB customers are also customers of Morgan Stanley & Co. LLC.⁷ Furthermore, MSSB is not registered with the CFTC as a swap dealer or a futures commission merchant; the lack of these registrations restricts its ability to transact in certain types of QFCs, including OTC derivatives. Finally, Morgan Stanley asserted that the extent and nature of its business with respect to client activity QFCs, as described above, support its view that granting the requested exemption would not impair or impede the FDIC's ability to exercise its rights under section 210(c)(8), (9), and (10) of the Act.

Treasury received a final recommendation from the FDIC, prepared in consultation with the SEC and CFTC, regarding the exemption request, and, after consultation with the FDIC, Treasury is making the determination discussed below.⁸

Evaluation of the Exemption Request

As discussed more fully in the preamble to the final rule,⁹ the FDIC has the authority under Title II of the Dodd-Frank Act to transfer the assets and liabilities of any financial company for which it has been appointed receiver under Title II (a "covered financial company") to either a bridge financial company established by the FDIC or to another financial institution.¹⁰ The FDIC generally has broad discretion under Title II as to which QFCs it transfers to the bridge financial company or to another financial institution subject to certain limitations, including the requirement that, if the FDIC is to transfer a QFC

⁷ Morgan Stanley & Co. LLC was not included within the exemption request.

⁸ All exemptions to the recordkeeping requirements of the rule are made at the discretion of the Secretary, and the Secretary's discretion is not limited by any recommendations received from other agencies. Exemptions to the FDIC's recordkeeping rules under 12 CFR Part 371 (Recordkeeping Requirements for Qualified Financial Contracts) are at the discretion of the board of directors of the FDIC and entail a separate request and process and separate policy considerations. References to the FDIC in this notice should not be taken to imply that the FDIC has determined that similar exemptions under Part 371 would be available.

⁹ See 81 FR at 75624-25.

¹⁰ See, e.g., 12 U.S.C. 5390(a)(1)(G)(i).

with a particular counterparty, it must transfer to a single financial institution (i) all QFCs between the covered financial company and such counterparty and (ii) all QFCs between the covered financial company and any affiliate of such counterparty.¹¹ Similarly, if the FDIC determines to disaffirm or repudiate any QFC with a particular counterparty, it must disaffirm or repudiate (i) all QFCs between the covered financial company and such counterparty and (ii) all QFCs between the covered financial company and any affiliate of such counterparty.¹² This requirement is referred to as the “all or none rule.”

Separately, if the FDIC is appointed receiver of a covered financial company that is a broker-dealer and the FDIC establishes a bridge financial company to assist with the resolution of that broker-dealer, the FDIC must, pursuant to section 210(a)(1)(O) of the Act,¹³ unless certain conditions are met, transfer to the bridge financial company all “customer accounts” of the broker-dealer and all associated “customer name securities” and “customer property,” as those terms are defined by reference to the Securities Investor Protection Act of 1970, as amended (“SIPA”).¹⁴ There are two conditions under which the FDIC is permitted not to transfer all such customer accounts, customer name securities, and customer property to the bridge financial company: (i) if the FDIC determines, after consulting with the Securities Investor Protection Corporation and the SEC, that such customer accounts, customer securities, and customer property are likely to be promptly transferred to another registered broker-dealer or (ii) if the transfer would materially interfere with the ability of the FDIC to avoid or mitigate serious adverse effects on financial stability or economic conditions in the United States.¹⁵ If neither such condition is met and a bridge financial company is established by the FDIC, the QFCs that would be transferred to the bridge

¹¹ 12 U.S.C. 5390(c)(9)(A)

¹² 12 U.S.C. 5390(c)(11).

¹³ 12 U.S.C. 5390(a)(1)(O).

¹⁴ 15 U.S.C. 78aaa *et seq.* See also section 201(a)(10) of the Dodd-Frank Act (12 U.S.C. 5381(a)(10)) (providing that the terms “customer,” “customer name securities,” and “customer property” as used in Title II shall have the same meaning as provided in SIPA).

¹⁵ 12 U.S.C. 5390(a)(1)(O)(i)(I)–(II).

financial company pursuant to section 210(a)(1)(O) would include QFCs entered into by the broker-dealer with its customers.

Not all of a broker-dealer's clients are treated as "customers" of that broker-dealer under SIPA. For instance, a client of a broker-dealer that engaged in an FX spot transaction or an FX forward would not be a "customer" under SIPA with respect to those transactions.¹⁶ Even if such a client were otherwise to have a customer relationship with the broker-dealer under SIPA, such as by virtue of having a brokerage account for the trading of securities, then, although that customer account would be required to be transferred pursuant to section 210(a)(1)(O) of the Act, the FX spot transaction or forward would not be required to be transferred pursuant to section 210(a)(1)(O) of the Act. However, pursuant to the all or none rule, if the FDIC were to transfer a customer account that held QFCs between the broker-dealer and the client, the FDIC would be required to transfer (i) all QFCs between the broker-dealer and the client and, if the client is a non-natural person, (ii) all QFCs between the broker-dealer and any affiliates of such client. For example, if the broker-dealer were a party to a margin loan with a client, the client would be deemed to be a customer for purposes of SIPA and thus the margin loan would be transferred pursuant to section 210(a)(1)(O) of the Act. If, in addition, the broker-dealer were also a party to an FX spot agreement with that same client, the client would not be deemed to be a customer for purposes of SIPA with respect to that FX spot agreement. Nevertheless, because the FDIC, pursuant to section 210(a)(1)(O) of the Act, would be required to transfer the margin loan to the bridge financial company, the FDIC also would be required to transfer the FX spot transaction, pursuant to the all or none rule.

In a contrasting example, a client could be a "customer" of MSSB under SIPA, such as by having a brokerage account with MSSB, yet not have any QFCs outstanding with MSSB in that account. If such a client had a QFC with MSSB that was not the type of QFC that would make it a customer under SIPA

¹⁶ See 15 U.S.C. 78III(2) (defining "customer" as ". . . any person (including any person with whom the debtor deals as principal or agent) who has a claim on account of *securities* received, acquired, or held . . ." (emphasis added); 15 U.S.C. 78III(14) (defining "security" to exclude currency and rights to buy and sell currency other than FX options and other derivatives executed on a national securities exchange).

(such as an FX spot agreement) and if the client (and, in the case of a non-natural person, its affiliates) had no other QFCs outstanding with MSSB, then that QFC would not be required to be transferred to the bridge financial company pursuant to either section 210(a)(1)(O) of the Act, because section 210(a)(1)(O) would not apply to that QFC, or the all or none rule, because the all or none rule would not apply if there were no other outstanding QFCs between the parties. However, given the limited nature of MSSB's business and the limited types of QFCs entered into by MSSB with its clients, as represented by Morgan Stanley, the likelihood that the FDIC would determine to retain such a QFC in the receivership despite transferring the customer account, customer name securities, and customer property of such customer would seem relatively low.

Determination of Exemption

Given the above-discussed restrictions on the FDIC's discretion as to whether or not to transfer QFCs from a broker-dealer, the limited nature of MSSB's business, and the limited types of QFCs entered into by MSSB with its clients, Treasury has determined to exempt MSSB from the recordkeeping requirements of the rule with respect to any QFCs of MSSB with clients that are customers of MSSB under SIPA with respect to any transactions or accounts they have with MSSB, subject to the conditions stipulated below.¹⁷ Treasury does not expect that granting this exemption will unduly interfere with the FDIC's ability to avoid or mitigate serious adverse effects on financial stability or economic conditions in the United States. In MSSB's case, the size, risk, complexity, and leverage of its QFCs with its customers do not present a high likelihood that the financial stability exception to the transfer requirement of section 210(a)(1)(O) of the Act would be met. If the financial stability exception is not met, the FDIC would likely either transfer, pursuant to section 210(a)(1)(O), all of a broker-dealer's customer accounts, customer name securities, and customer property included in such customer accounts and any other QFCs with such customer to the bridge financial company or transfer all such accounts, securities, and property

¹⁷ As used in the remainder of this notification of exemption, the term "customer" means a person who is a customer as defined in SIPA with respect to any transaction or account it has with MSSB.

to another broker-dealer. In either case, the FDIC would not need the detailed records required by the rule with respect to QFCs to accomplish the transfer.

Treasury is also exempting MSSB from the recordkeeping requirements of the rule with respect to any QFC entered into by MSSB with a clearing organization for the purpose of facilitating the clearance or settlement of any QFC subject to the exemption discussed above. As used in the exemption, the term “clearing organization” includes, among other things, clearing agencies registered with the SEC and derivatives clearing organizations registered with the CFTC.¹⁸ The records required by the rule regarding such clearing organization QFCs should not be needed by the FDIC to address the clearance or settlement of MSSB’s exempted customer QFCs.

Further, given the limited nature of MSSB’s business and the limited types of QFCs entered into by MSSB with its clients, Treasury is exempting MSSB from the recordkeeping requirements of the rule with respect to any QFC between MSSB and an affiliate of MSSB if (i) the affiliate is required to maintain the records described in section 148.4 of the rule and (ii) the QFC is entered into by MSSB in order to enable MSSB to fulfill its obligations under QFCs with its customers or to hedge risk arising from QFCs with its customers. Such QFCs could include, for example, a securities lending agreement MSSB may enter into with an affiliate in order to obtain securities to lend to MSSB’s customers or a QFC MSSB may enter into with an affiliate to hedge risk arising from QFCs MSSB engages in with its customers. Treasury is limiting the scope of this exemption to QFCs with affiliates of MSSB that are themselves records entities because if the FDIC is appointed as receiver of MSSB, the FDIC would, by reference to records of the inter-affiliate QFCs maintained by such affiliated records entities, be able to decide whether or not to transfer such QFCs to a bridge financial company. Treasury has determined not to provide an exemption with respect to such QFCs with affiliates of MSSB that are not records entities

¹⁸ The exemption cross-references the definition from section 402 of the Federal Deposit Insurance Corporation Improvement Act of 1991, 12 U.S.C. 4402.

because the size of such QFCs and the risks they impose could be such that the FDIC would need the records required by the rule to make a transfer determination.

Conditions of the Exemption

The exemption granted below is based on the factual representations made by Morgan Stanley on behalf of MSSB to Treasury, the FDIC, the SEC, and the CFTC in its submissions, including the factual representations regarding MSSB's registration as a broker-dealer, investment advisor, and introducing broker, the limitations on its business lines, the limitations on the types of clients it serves and the types of products and services it offers its clients, the frequency, size, and dollar amounts of QFCs with clients, the lack of complexity of the QFCs it has with clients, and the number of client accounts it maintains.

Treasury reserves the right to rescind or modify the exemption at any time. Further, Treasury intends to reassess the exemption in five years. At that time, Treasury, in consultation with the FDIC and the primary financial regulatory agencies, would evaluate any material changes in the nature of MSSB's business as well as any relevant changes to market structure or applicable law or other relevant factors that might affect the reasons for granting the exemptions. Treasury may request an updated submission from MSSB as to its business at that time. Treasury expects that it would provide notice to MSSB prior to any modification or rescission of the exemption and that, in the event of a rescission or modification, Treasury would grant MSSB a limited period of time in which to come into compliance with the applicable recordkeeping requirements of the rule.

TERMS AND CONDITIONS OF THE EXEMPTION

MSSB is hereby granted an exemption from the requirements of 31 CFR 148.3 and 148.4 for (i) any QFC entered into by MSSB with or on behalf of any customer of MSSB that is booked and carried in accounts at MSSB maintained for the benefit of such customer; (ii) any QFC entered into by MSSB with a clearing organization in order to facilitate the clearance or settlement of any QFC referenced in clause (i); and (iii) any QFC entered into by MSSB with an affiliate of MSSB in order to enable MSSB to

fulfill its obligations under QFCs referenced in clause (i) or to hedge risk arising from QFCs referenced in clause (i), provided that such affiliate is a records entity required to maintain the records specified in 31 CFR 148.4. For purposes of the exemption, “customer” means a person who is a customer as defined in 15 U.S.C. 78ll(2) with respect to any transactions or accounts it has with MSSB, and “clearing organization” has the meaning provided in 12 U.S.C. 4402.

The exemption is subject to modification or revocation at any time the Secretary determines that such action is necessary or appropriate in order to assist the FDIC as receiver for a covered financial company in being able to exercise its rights and fulfill its obligations under sections 210(c)(8), (9), or (10) of the Act. The exemption extends only to MSSB and to no other entities.

Dated: December 17, 2018

Peter Phelan
Deputy Assistant Secretary for Capital Markets

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